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In the Supreme Court of the United States

October Term 2001

Leon C. Baker P.C. and Leon C. Baker, individually,
Petitioners

v.

Merrill Lynch, Pierce, Fenner & Smith Inc.,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF ALABAMA

Arthur R. Miller
Attorney for Petitioner
1545 Massachussetts Avenue
Cambridge, Massachussetts 02138
Telephone: (617) 495-4111

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QUESTION PRESENTED

If a contract governed by the Federal Arbitration Act, 9 U.S.C. § 2 ("FAA"), provides that "all disputes arising hereunder shall be submitted to arbitration," should disputes about preclusion (res judicata and collateral estoppel) nevertheless be ruled on by judges, rather than by arbitrators?

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PETITION FOR A WRIT OF CERTIORARI
TO THE SUPREME COURT OF THE
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Petitioners, Leon C. Baker, P.C. ("P.C.") and Leon C. Baker ("Baker") pray that a Writ of Certiorari be issued to review the opinion and judgment of the Supreme Court of Alabama entered on August 31, 2001.

Opinions Below

The opinion of the Circuit Court of Jefferson County, Alabama, is not reported. A copy is set forth at page A-1of the Appendix.

The opinion of the Alabama Supreme Court is set forth at page C-1 of the Appendix. It is not yet reported in South 2d.

Jurisdiction

The opinion of the Alabama Supreme Court was entered on August 31, 2001. An application for rehearing was filed on September 13, 2001 and was denied on November 16, 2001. This Petition for a Writ of Certiorari was filed within ninety days of the denial. The Court's jurisdiction is invoked under 28 U. S.C. § 1257(a).

Constitutional and Statutory Provisions Involved

Article II, Section 3 of the United States Constitution provides in pertinent part:

> **The Congress shall have the Power * * * To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes * * *.**

Article IV, Section I of the United States Constitution provides in pertinent part:

> **Full faith and credit shall be given in each state to the public acts, records, and judicial proceedings of every other state.**

The Fourteenth Amendment to the United States Constitution provides in pertinent part:

> [N]or shall any state deprive any person of life, liberty, or property, without due process of law * * * .

The Federal Arbitration Act, Section 2, provides in pertinent part:

> A written provision in any maritime transaction or a contact evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, shall be valid, irrevocable, and enforceable * * *.

Corporate Disclosure Statement

Petitioner, Leon C. Baker P.C., is a New York professional corporation authorized to practice law in that state. The P. C.'s sole shareholder is Leon C. Baker. It has no subsidiaries.

STATEMENT OF THE CASE

A. Nature of the Case

The P.C. has a securities brokerage account with Respondent, Merrill Lynch, Pierce, Fenner & Smith Inc. ("Merrill Lynch") and signed the form of agreement Merrill Lynch requires its customers to execute. The

agreement provides that the parties will submit "all" disputes to arbitration. A dispute did arise, the details of which are set forth later in this Petition. The parties were unable to resolve the dispute by negotiation, and the P.C. sued Merrill Lynch in Florida, the state in which Baker, its sole shareholder, has been a resident and citizen since 1989.

Merrill Lynch moved to require arbitration. When reminded of the arbitration provision, the P.C. did not oppose Merrill Lynch's motion. The Florida court entered an agreed order directing arbitration and retained jurisdiction to enforce any award which might be entered.

The P.C. commenced an arbitration proceeding before the National Association of Securities Dealers, Inc. ("NASD"), the tribunal selected by Merrill Lynch pursuant to its arbitration agreement. Merrill Lynch filed an answer alleging res judicata as its principal defense. As is set forth more fully below, the P.C. maintains that res judicata is not applicable based both on the facts and on the law.

The NASD then submitted a list of prospective Florida arbitrators, from which a panel of three were to be appointed. The P.C. selected three lawyers from the NASD list. Merrill Lynch did not object to any of the P. C.'s nominees; nor did Merrill Lynch submit any alternative nominees. Accordingly, the arbitration panel would have consisted of three lawyers.

On the very eve of the hearing, without any notice to the P.C. or to the Florida court that had ordered arbitration, Merrill Lynch obtained from an *Alabama* trial court an ex parte restraining order prohibiting the P.C. and Baker from proceeding with the arbitration. [1]

B. The Rush to Judgment

The irreparable injury that Merrill Lynch alleged as the ground for equitable relief against the arbitration was that it asserted a defense of res judicata which, Merrill Lynch argued, non lawyer arbitrators would not understand (ignoring the fact that all the chosen arbitrators were lawyers). Baker and the P. C. objected that an Alabama court could not interfere with an arbitration ordered by a Florida court, and that Merrill Lynch had waived any right it might have had to object to arbitration, first, by seeking arbitration, and, second, by participating in it. Moreover, the P.C. showed that res judicata was not applicable because, as is more fully set forth below, the P.C. was not a party to the earlier proceedings and could not have appealed. Both the Alabama trial court and the Alabama Supreme Court

1. Merrill Lynch may have elected to sue in Alabama, rather than in Florida, among other reasons, because Alabama is notoriously hostile to arbitration. See Ala. Code 8-1-41, which invalidates agreements to arbitrate entered into before a claim has arisen.

rejected these objections and entered final judgment in favor of Merrill Lynch.

Although these were serious errors, the P.C. and Baker are not seeking certiorari with respect to them, paradoxically, because there is no conflict among the circuits (or state courts) a) that demanding and participating in arbitration waive any objections to arbitration, and b) that a non-appealable order can have no preclusion effect. Of course, if this Court grants certiorari on the grounds set forth in this Petition, the Court could reverse for those errors as well.

The Alabama trial court held that the P.C.'s claim was barred by res judicata and granted a permanent injunction. On appeal Merrill Lynch dropped its misrepresentation that the Florida arbitrators would be non-lawyers. Instead it argued that 1) despite the arbitration provision in Merrill Lynch's customers agreement requiring that *all* disputes be arbitrated, and 2) despite the FAA, actions in which the defendant avers a defense of preclusion (res judicata or collateral estoppel) must be submitted to courts rather than arbitrators. The Alabama Supreme Court affirmed a) the ruling of the trial court that the P.C. was barred by res judicata and b) the issuance of the permanent injunction.

C. The Facts

Neither the P.C. nor Merrill Lynch were parties to the original dispute and the lawsuits that ultimately gave rise to the arbitration and the present lawsuit. The prior litigation on which Merrill Lynch bases its preclusion defense was between Baker and J. R. Bennett and Laura Bennett, all residents of Florida. There were a total of four lawsuits in Alabama between Baker and the Bennetts, denominated in the Alabama Supreme Court 's opinion (Appendix C-2) as "Alabama-Baker I" through "Alabama-Baker IV."

Those four lawsuits arose out of a computer leasing transaction more than twenty years ago between persons completely unrelated either to the present litigation or to the lawsuits by the Bennetts against Baker in Alabama. Those persons were Gibbs and West, the owners of a coal mine in Alabama, and Atlantic Computer Leasing Ltd., an English computer lessor ("Atlantic"). Baker, then practicing law in New York, represented Atlantic.

In 1980 oil prices were very high as a result of the production restrictions of OPEC. This created a strong demand for coal, and Gibbs and West's Alabama mine became very profitable. They invested their profits and all the money they could borrow in digging shafts and tunnels and purchasing mining equipment. Near year

end, they realized they did not have, and could not borrow, enough funds to pay their income taxes.

Their Alabama accountants, who had worked with Baker on tax matters for other clients, telephoned him in New York and asked him to find a computer leasing "tax shelter" for Gibbs and West. Such "tax shelters" do not produce tax saving.They only defer taxes. Taxes "saved" during an initial five year accelerated depreciation period have to be paid during later years, when there are no depreciation deductions. What the investor receives from such a "tax shelter" is, in effect, an interest free "loan" from the United States Treasury. For Gibbs and West, though, this was exactly what they needed. They asked Baker to find them a computer leasing transaction. He did so with his client, Atlantic. Gibbs and West survived their cash crisis.

Six months later the accountants for Gibbs and West telephoned Baker to inform him that they had sold their mine and no longer needed tax deferral. The accountants added that they had another client, J. R. Bennett, who had a similar problem. Bennett's mobile home business was very profitable, but it was also expanding very rapidly, and he was short of cash. He wished to solve his problem by acquiring from Gibbs and West a half interest in their contracts with Atlantic. The accountants requested that Baker ask his client to

consent, which Atlantic did. Baker received no fee for his services.

Nine years later the Internal Revenue Service challenged the deductions J. R. Bennett and his wife had taken, and they paid approximately $850,000 of deferred taxes and interest. The taxes, of course, would have been payable later in any event. Moreover, the Bennetts received a tax deduction for the interest they paid. Thus their actual loss was small--particularly when compared with the value of saving Bennett's business. Nevertheless, the Bennetts sued Baker for $850, 000 plus punitive damages. The Alabama Supreme Court refers to that case as "Alabama-Baker I."

The Bennetts asserted two theories: First that Baker had acted as Bennett's attorney and had advised Bennett erroneously of the tax consequences of the transfer from Gibbs and West. The Huntsville, Alabama trial court directed a verdict dismissing this count. Second, the Bennetts alleged that Baker had committed intentional fraud in representing that a computer leasing transaction would provide a good tax shelter. Since the correctness of Baker's legal opinion was a matter of law for the court, Baker urged, based on Federal tax authorities, that the fraud count also should be dismissed. The court, however, simply left the tax issue for the jury to decide without any instructions on Federal tax law.

The jury returned a verdict, for compensatory damages of $440,000 but no punitive damages. The Alabama Supreme Court affirmed. It held that, although there was no evidence of intentional misrepresentation or failure to disclose facts, the jury could have found liability for innocent misrepresentation or innocent non-disclosure.

This was an unprecedented ruling since, both under prior Alabama law and general common law, there can be no damages for innocent misrepresentation or non-disclosure. The remedies are rescission or reformation, but neither of those remedies could have been obtained against Baker, because he was not a party to the original transaction between Gibbs and West and Atlantic Computer Leasing Ltd. or the subsequent assignment by Gibbs and West of a half interest to Bennett. Six years later, in *State Farm Fire & Cas. Co. v. Owen*, 729 So.2d 834 (Ala.1998), the Alabama Supreme Court overruled its decision against Baker in Alabama–Baker I. By then it was too late for Baker to reopen the case.

The action which the Alabama Supreme Court refers to as Alabama-Baker II arose out of the Bennetts' efforts to collect their judgment in Alabama even though Baker is not a resident of Alabama and has no assets there. The Bennetts served garnishments on the Alabama offices of a number of national securities firms. Baker never had an account with any of those Alabama offices, but the Bennetts contended that service on the Alabama offices required the

offices required the firms to deliver Baker's assets they held in offices outside Alabama.

The Huntsville court held that garnishment may not be used to reach a non-resident's assets by serving a resident bailee who holds the assets outside the state. The firms could be regarded as residents of Alabama, because of their local offices, but the assets of out-of-state customers held in other states could not be garnished in Alabama. With regard to the use of equity power, the court held that the Alabama Constitution, which prohibits imprisonment for debt, bars enforcement of money judgments by contempt proceedings.

In the lawsuit the Alabama Supreme Court refers to as "Alabama-Baker III," the Bennetts' lawyers successfully evaded the decision in Alabama-Baker II. They did so through the initial negligence of Merrill Lynch and its subsequent complicity.

The Bennetts' lawyers brought a new action in a different Alabama venue, in Birmingham. They served discovery notices on the major national securities brokerage firms, including Merrill Lynch, demanding copies of statements of any accounts Baker might have with them. Baker moved to dismiss on the ground of res judicata, but the court never ruled on his motion.

It was at this point, through the gross neglect of Merrill Lynch, that the P.C. was dragged into the

litigation. The P.C. had, and still has, a brokerage account with Merrill Lynch. When Merrill Lynch sent out monthly account statements, it abbreviated the name on the P.C.'s statements to "Leon C. Baker," omitting the corporate designation "P.C."

Over the years the P.C. had objected that its account name should be stated correctly, including "P.C." Merrill Lynch responded that the P.C. need not be concerned because the name was shown correctly on its internal account records. Nevertheless, the P. C. insisted that the statements be issued with the correct name. Merrill Lynch finally complied—but, unfortunately, not until after the disastrous events of Alabama-Baker III.

Merrill Lynch responded to the Bennetts' discovery request in the Birmingham action with a monthly statement of the P.C. but with "P.C." omitted! Based on this statement, the court directed Merrill Lynch to liquidate a Treasury bill in the P.C.'s account and to pay $723,353 to the Bennetts' attorneys.

Merrill Lynch responded by submitting an affidavit of its executive responsible for the P.C.'s account, who stated that the actual name on Merrill Lynch's records was "Leon C. Baker P.C." and that Merrill Lynch had made an error. Even so, the Birmingham court refused to

withdraw its order.[2]

At this point, only Merrill Lynch could appeal from the payment order. Baker could not, because his property had not been seized. The P.C. could not, because, under Alabama law, only parties can appeal. Merrill Lynch was a bailee that had made a mistake with respect to its bailor's property, which it was obligated to take legal action to protect. It could have intervened, appealed, and posted a bond rather than pay over the funds. Merrill Lynch chose not to do so.

Instead, Merrill Lynch sought to protect itself at the expense of its customer. It proposed that it would waive its objection and pay the $723,353 to the Bennetts if the court entered an order releasing Merrill Lynch from any liability to the P.C. for doing so. Counsel for the Bennetts prepared that order. Baker's assent was not required, because he claimed no interest in the account. The P.C. was not a party, and its consent was not sought. Nevertheless, Merrill Lynch contends that the order provides it with a preclusion defense on two points: 1) that Merrrill Lynch has no liability to the P. C. and 2) that the account belongs to Baker, not the P.C.

2. The Alabama Supreme Court, at page 3 of its opinion in the present case, noted that "the account had been opened in the name of Leon C. Baker P.C., ostensibly a corporate account of the P.C., rather than as an individual account of Baker"[emphasis by the court].

As an alternative basis for preclusion barring the Florida arbitration Merrlll Lynch relies on the "fact" that Alabama–Baker III was affirmed in Alabama-Baker IV. True there was an affirmance, but the appeal was solely by Baker on an unrelated issue. Since the P.C. was not a party to the action, under Alabama law it could not appeal even though its property had been seized. Consequently the order could not be, and was not, appealed or affirmed in Alabama-Baker IV and could not give rise to preclusion.

D. The Question Presented for Review By This Court Was Raised In The Alabama Courts

When Merrill Lynch sought an injunction in the Alabama trial court against the arbitration which was about to be tried in Florida, the P.C. and Baker filed a memorandum of law in opposition. The caption of a major point of the memorandum was the following:

> THE INJUNCTION MERRILL IS SEEKING IN THIS ACTION IS BARRED BY THE FEDERAL ARBITRATION STATUTE.

In support, the P.C. and Baker cited, among other authorities, this Court's holding in *Southland Corp. v. Keating*, 465 U.S. 1 (1984). They argued that Congress has declared a national policy favoring arbitration and has withdrawn the power of the states to require a judicial forum for the resolution of claims

which the contracting parties agreed to resolve by arbitration. The trial court, nevertheless, permanently enjoined the Florida arbitration.

In the Alabama Supreme Court, Baker and the P. C. argued: "The Federal Arbitration Act applies to arbitration agreements involving interstate commerce and preempts state law with respect to such agreements." That court, however, affirmed and denied reargument.

E. Reasons For Granting The Writ

There is a growing division of authority among the United States Courts of Appeals and among various state courts of last resort as to whether there should be a judicially created exception to Section 2 of the FAA for cases in which one party to an arbitration agreement asserts preclusion. The usual rationale advanced for creating such an exception is that preclusion law is recondite and beyond the ken of lay arbitrators.

Another, much narrower, rationale for reading in an exception to the federal statute for preclusion defenses was articulated by the Alabama Supreme Court (and by some United States Courts of Appeals). It is that the rendering court is better able to determine what was decided than arbitrators. However, the rendering court and the enforcing court are often entirely different tribunals. This defect in the theory is illustrated by this

very case. The judge who decided Alabama-Baker III was no longer on the court. The Alabama judge in the present case was just as uninformed about the earlier case as the Florida arbitrators would have been.

POINT I

BOTH FEDERAL AND STATE COURTS ARE SHARPLY DIVIDED AS TO WHETHER REQUIRING A JUDGE TO DECIDE PRECLUSION ISSUES IN A DISPUTE GOVERNED BY AN ARBITRATION AGREEMENT VIOLATES SECTION TWO OF THE FEDERAL ARBITRATION ACT.

The contract between the P.C. and Merrill Lynch, relates to interstate commerce because it covers sales and purchases on stock exchanges, through NASDAQ and in over-the-counter securities markets. In disputes under contracts which arise out of interstate commerce, the FAA requires federal and state courts to enforce arbitration provisions. In *Southland Corp. v. Keating*, 465 U.S. 1 (1984), this Court said :

> In enacting § 2 of the federal Act, Congress declared a national policy favoring arbitration and withdrew the power of states to require a judicial forum for the resolution of claims the contracting parties agreed to resolve by arbitration.

Id. at 9.

The United States Courts of Appeals disagree as to whether, when parties have agreed to arbitrate all their disputes under a contract governed by the FAA, a defense of preclusion nevertheless should be decided by a judge. As shown below, early cases did not take the FAA into account in holding that judges, rather than arbitrators, should rule on a preclusion defense. More recent cases, but by no means all, hold that if the parties agreed to arbitrate *all* their disputes under the contract, the FAA requires that the arbitrators, not a judge, should rule on a preclusion defense. It is primarily because of this disagreement among the circuits that this Petition should be granted.

An early reported federal case was *Clements v. Central Railroad Co. of New Jersey*, 399 F.2d 825 (3d Cir.1968). Both the trial court and the Third Circuit assumed that the court was required to consider the preclusive effect of a prior judgment before compelling the parties to arbitrate. Another Third Circuit decision sometimes cited for the same proposition is *Telephone Workers of New Jersey v. New Jersey Bell Tel. Co.*, 584 F.2d 31 (3d Cir. 1978). However, that was not the issue on which the court decided that case. In fact, it did not even consider that issue. In *John Hancock Mutual Life Ins. Co. v. Olick*, 151 F.3d 132 (3d Cir. 1998), the Third Circuit had it both ways. It held that judges should rule on claims of preclusion based on prior judgments but that arbitrators should rule on claims of preclusion based upon prior awards.

In *Miller Brewing Co. v. Fort Worth Distributing*, 781 F.2d 494 (5th Cir. 1986), Miller and Fort Worth Distributing (referred to as "FWDC"in the court's opinion) entered into an agreement under which FWDC distributed Miller beer. The agreement provided that if Miller terminated the agreement without cause, an arbitration panel could order Miller to pay compensatory damages.

Miller did terminate and FWDC sued in a Texas state court. Miller removed to a federal district court but the Fifth Circuit remanded. FWDC took no steps to schedule arbitration until almost four years later, when its state court action was about to be dismissed for want of prosecution. Miller's attempt in a federal district court to enjoin the arbitration was denied. The Fifth Circuit reversed, holding that FWDC waived its right to arbitrate by taking depositions and by other activities before the state lawsuit was dismissed. In dictum, the Fifth Circuit added that the action also could have been dismissed on the ground of res judicata. Although FWDC had not sought damages in its state lawsuit (only an injunction), it could have. The court noted:

> **The doctrine of res judicata * * * and its cousin collateral estoppel have probably done more to prevent useless and wasteful litigation than arbitration ever could.**

Id. at 497 n.3.

That dictum and supposition are not much of a precedent for the proposition that only judges, and not arbitrators, should rule on res judicata and collateral estoppel. Nevertheless, they were followed by some Courts of Appeals. The first was *Kelly v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 985 F.2d 1067 (11th Cir. 1993). Kelly sued Merrill Lynch in a federal district court alleging violations of SEC Rule 10b-5. After the district court dismissed the complaint, Kelly began an arbitration on related state law claims.

The Eleventh Circuit affirmed an injunction against arbitration of the state law claims primarily on the authority of the *Miller Brewing* case but there was one important difference between the cases. In *Miller Brewing* the ground for enjoining the arbitration was that the defendant, FWDC, had waived arbitration by pursuing its failed lawsuit. The Eleventh Circuit ignored this holding and focused on the dictum that *Miller Brewing* might have been dismissed on the ground of res judicata. It declared:

> **Courts should not have to stand by while parties re-assert claims that have already been resolved.**

Id. at 1069. It cited as authority the Fifth Circuit's speculation that res judicata has "probably done more to prevent useless and wasteful litigation than arbitration ever could." Id. at 269.

In *Y & A Securities Litigation*, 38 F.3d 380 (8th Cir. 1994), the court considered the preclusion effect of a settled class action. In particular, the court explored whether claim preclusion applies either for or against class defendants who were not actual parties. The class action was brought in a United States district court in Missouri alleging "fraud on the market," which inflated the price of Y & A stock. The settlement was incorporated into a district court consent judgment.

Dean Witter Reynolds Inc., a securities brokerage firm, was not a defendant in the class action. Volk, a customer, and a member of the plaintiff class, commenced an arbitration against Dean Witter under its customers agreement. Volk alleged that he had incurred losses on Y & A stock because a Dean Witter broker forged his signature on a margin account agreement "well before the period covered by the class settlement." Dean Witter then obtained, on the ground of res judicata, a preliminary injunction from the federal district judge who had entered the consent judgment barring the arbitrators from proceeding. The Eighth Circuit affirmed.

The court's decision is cited as authority that a court, rather than arbitrators, should decide a res judicata issue. It is an authority, but it is not a strong one. Only a preliminary injunction was appealed. The Eighth Circuit did not have to, and did not, reach the merits. It only had to determine that the district court's

legal analysis was plausible and might be sustained on an appeal from a final order. The opinion declared:

> **Here the district court * * * has concluded that Dean Witter is likely to be able to prove that the class plaintiffs intended to release for free third party brokers like Dean Witter for bad acts which 1) Y & A had no responsibility for and could not possibly be indemnified for; and 2) affected individuals rather than the class. While at first blush this may appear to be a surprising outcome, we are not convinced the district clearly erred in so holding."**

Id. at 384. Chief Judge Arnold, concurring in the judgment, declared:

> **In general, when parties agree to submit a matter to arbitration, they contract for the arbitrator's decision on legal questions as well as on issues of fact. Such legal questions would include defenses, such as res judicata, and I do not read this Court's opinion today to hold generally that courts may by injunction, control the decision of arbitrators on questions of issue or claim preclusion.**

Id. at 384.

The Seventh Circuit, in a dictum, has speculated

"if the party opposing arbitration on grounds of collateral estoppel asks the court to enjoin arbitration before there is any award, * * * the court will have to decide whether to refuse or order arbitration * * *." ***Miller v. Runyon,*** **77 F.3d 189, 194 (7th Cir.1996).**

There is no ambiguity in the contrary holding of the Second Circuit in *National Union Fire Ins. Co. of Pittsburgh Pa. v. Belco Petroleum Corp.*, 88 F.3d 129 (2nd Cir. 1996), that Section 2 means exactly what it provides. In brief the statute does not permit issues to be decided by courts which the parties have agreed to submit to arbitration.

The case arose out of the seizure of Belco's oil fields and equipment by the Peruvian government. The dispute was between Belco and a group of insurance companies which had issued policies insuring Belco against expropriation. The insurers sought to rescind the policies alleging that Belco had made misrepresentations. The policies provided that all disputes arising under them should be arbitrated, and the arbitrators awarded Belco approximately $145 million plus interest.

Belco later recovered $3 million from a different insurer for vessels taken by the Peruvian government. The insurers who had paid the earlier award demanded a portion under a provision in their policies that proceeds collected from other insurance should be shared between them and Belco. When Belco disputed

this claim, the insurers initiated a second arbitration. Belco sought a declaratory judgment that the claim was barred by res judicata, and the insurers countered with a petition to compel arbitration. The district court ruled that under federal law the arbitrators had to decide the preclusion issue. The Second Circuit affirmed, reasoning:

> **Belco's claim of preclusion is a legal defense to National Union's claim. As such it is itself a component of the dispute on the merits. Belco's attempt to characterize the preclusion issue as not related to the merits is unavailing. It as much related to the merits as a time limit in the arbitration agreement or laches. * * ***
>
> **The [arbitration] provision covers "all disputes which may arise under *or in connection with this policy*"[emphasis added by the court], and is not limited, as Belco contends, to disputes that require interpretation of the AIG policy. We do not believe the arbitration provision is ambiguous, but even if it were, the FAA would require resolving any ambiguity in favor of arbitration.**

Id. at 135.

The Alabama Supreme Court (at Appendix C-10) sought to limit *Belco* by declaring that it held only "that the preclusive effect of a prior arbitration

proceeding on claims asserted in a subsequent arbitration proceeding is arbitrable." Four months after *Belco*, however, the Second Circuit elaborated its position on the preclusive effect of a prior judgment in *National Fire Ins. Co. v. National Gypsum Co.*, 101 F. 3d 813 (2d Cir. 1996). The district judge granted an injunction against arbitration of a claim he held was precluded by his affirmed decision in a prior case. In reversing, the Second Circuit said:

> **Our decision is consistent with our recent holding that the issue-preclusion effect of a prior arbitration is arbitrable and must be arbitrated. *Belco*, 88 F.3d at 135-36. In *Belco* we rejected the argument that issue preclusion is not related to the merits of an agreement and nonarbitrable, noting that "Belco's claim of preclusion is a legal defense to National Union's claim. As such it is a component of the dispute on the merits." *Belco*, 88 F.3d at 135. Although the present dispute involves the preclusive effect of a prior judgment, Wellington's arbitration agreement covers "any disputed issues " within [its] scope. Thus a defense based on the issue preclusive effect of a prior judgment is part of the dispute on the merits**

Id. at 817. The Alabama Supreme Court's narrow interpretation of *Belco* is obviously erroneous.

In *Chiron Corp. v. Ortho Diagnostic Systems*,

Inc., 207 F.3d 1126 (9th Cir. 2000), the district court confirmed an arbitration award. The Ninth Circuit aligned itself with the Second Circuit, declaring:

> Like the agreement in *Belco*, Chiron and Ortho's arbitration agreement is undeniably broad. Ortho's res judicata defense to a subsequent arbitration proceeding necessarily involves an inquiry into Chiron's underlying claims. As with respect to other affirmative defenses, such as laches and the statute of limitations, we agree with the Second Circuit that a res judicata defense is a "component" of the merits of the dispute and is thus an arbitrable issue.

Id. at 1134.

The manifest split in the United States Courts of Appeals demonstrated above exists as well among state courts. The division is not only in cases in which the state courts are applying their domestic laws, but also when the FAA requires them to apply federal law.

The Alabama Supreme Court in this case, for example, cited *Rembrandt Indus. Inc. v. Hodges International, Inc.*, 38 N.Y. 2d 502, 381 N.Y.S.2d 451, 344 N. E. 2d 383 (1976). (App. C.13) The arbitration defendant brought suit on a counterclaim, alleging that the arbitrators had refused to consider it. The plaintiff responded that the arbitrators had rejected the counterclaim and that it was barred by res judicata. A

divided New York Court of Appeals held that the lower court had not abused its discretion in permitting res judicata to be pleaded as a defense. Neither party demanded arbitration so the issue was one for the court. By contrast, when the parties have agreed to arbitrate all their disputes, as in this case, the same court held that arbitrators are to determine preclusion issues. *Board of Education v. Patchogue- Medford Congress of Teachers*, 48 N.Y. 2d 812, 424 N.Y.S.2d 122, 399 N.E.2d 1143 (1979).

A Virginia case cited by the Alabama Supreme Court, *Waterfront Construction, Inc. v. North End 49ers*, 51 Va. 417, 468 S.E.2d 894 (1996)(*en banc*), discusses the role of courts and arbitrators with respect to preclusion issues. It held that a court rather than arbitrators should rule on the res judicata effect of an arbitration when the parties had not agreed to arbitrate that issue.

Given the major conflict of authority among the United States Courts of Appeals and the highest courts of some states as to whether preclusion defenses are to be ruled on by arbitrators or solely by courts, this Petition for Certiorari should be granted. Only this Court can provide a much needed uniform construction of the FAA on this important and recurrent issue.

POINT II

WHETHER COURTS MAY CREATE EXCEPTIONS UNDER THE FEDERAL ARBITRATION ACT FOR PRECLUSION ISSUES WHEN THE PARTIES HAVE CONTRACTED TO SUBMIT "ALL" DISPUTES TO ARBITRATION CALLS INTO QUESTION IMPORTANT FEDERAL POLICIES AND THE DIVISION AMONG THE FEDERAL AND STATE COURTS ON THIS POINT IS WORTHY OF THIS COURT'S ATTENTION.

The present case is a perfect vehicle for this Court to resolve the manifest conflict among the federal Courts of Appeals and state courts, because the question is squarely presented without diversionary side issues. The Merrill Lynch customers agreement provides that "all" disputes under it shall be submitted to arbitration. It indisputably relates to interstate commerce. Nor are there any factual disputes which detract from the clarity of the legal issues.

The issue in this case is important and "ripe" for determination. As this Court has noted, courts have not suffered arbitration gladly. *Bernhardt v. Polygraphic Co. of America,* 350 U.S. 198, 211 (1958). The history of arbitration in this Court is the abrogation, step by step, of the reluctance of lower courts to accept arbitration as a substitute for litigation. *In Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265 (1995), this Court summarized the history as follows:

First, the basic purpose of the Federal Arbitration Act is to overcome courts' refusals to enforce agreements to arbitrate . * * * The origins of those refusals apparently lie in "ancient times," when the English courts fought for "extension of jurisdiction----all of them being opposed to anything which would deprive every one of them of jurisdiction * * *." American courts initially followed the English practice, perhaps just "stand[ing] . . . upon the antiquity of the rule"prohibiting arbitration clause enforcement rather than "upon its excellence or reason"* * *. Regardless, when Congress passed the Arbitration Act in 1925, it was "motivated, first and foremost, by a * * * desire" to change this antiarbitration rule* * *. It intended courts to "enforce [arbitration] agreements into which parties entered * * * upon the same footing as other contracts * * * ."

Id. at 270.

This Court has rejected contentions 1) that the FAA applies only in federal question cases, *Prima Paint Corp. v. Flood & Conklin, Mfg. Co.*, 388 U.S. 395 (1967), 2) that the FAA does not preempt conflicting state (Alabama) anti-arbitration law, *Allied Bruce Terminix Co., supra*, and 3)

that the FAA does not supersede state law prohibiting arbitrators from awarding punitive damages. *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52 (1995).

Although the P.C. argued in the Alabama courts that the FAA requires them to give effect to the agreement of the parties that "all "their disputes should be resolved through arbitration, there is no mention of the FAA in either the ruling of the Alabama trial court or the decision of the Alabama Supreme Court.

Judges who have taken it upon themselves to rule on preclusion issues, despite agreements of the parties that all disputes be resolved by arbitration, in effect have viewed themselves as quasi parties to the controversy. The judges feel free to override the agreement of the parties on the theory that a) the judges have an independent interest in their prior rulings and b) they have not agreed to submit *their* contentions to arbitration. That is a fundamental error which this Court should correct.

Section 2 of the FAA and the decisions of this Court establish the importance of arbitration, and seek to overcome the reluctance of courts to enforce arbitration contracts. Only this Court can determine the propriety, or impropriety, of courts extracting issues--such as preclusion but potentially other matters as well--from arbitration, either because they are deemed too complex or for some other reason.

The issue presented by this Petition is critical to the arbitration process and currently is the subject of highly divergent judicial decisions both on the federal and state levels. A uniform principle needs to be be established, because the scope of arbitration under the FAA should not depend on the fortuity of the Circuit or state court in which the dispute arises or be subject to forum shopping of counsel seeking to halt arbitration. Moreover, the declaration of a uniform principle would eliminate the unseemly business of a court in one state (Alabama) enjoining an arbitration ordered by a court of another state (Florida) as occurred in this case.

CONCLUSION

This petition for a writ of certiorari should be granted.

Respectfully submitted,
Arthur R. Miller
Attorney for the Petitioner
1545 Massachussetts Ave.
Cambridge, Massachussetts 02138
Telephone: (617) 495-4111